Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RECEIVED

JAN 16 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the matter of	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
Treatment of Operator Services Under Price Cap Regulation	)	CC Docket No. 93-124
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

BELL ATLANTIC REPLY COMMENTS

Edward D. Young, III
Of Counsel

Michael E. Glover
Edward Shakin

1320 North Court House Road
Eighth Floor
Arlington, VA 22201
(703) 974-4864

Attorneys for the
Bell Atlantic Telephone Companies

January 16, 1996

TABLE OF CONTENTS

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Treatment of Operator Services Under Price Cap Regulation	)	CC Docket No. 93-124
	)	
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

BELL ATLANTIC [1] REPLY COMMENTS

The Commission proposes in this proceeding to consider specific changes to interstate access price regulation that "rely more heavily on market forces to achieve our public policy goals" and thereby "regulate noncompetitive markets in the most efficient and least intrusive way."[2] As Bell Atlantic demonstrated in its initial comments, the proposed rule changes offer only incremental improvements toward those goals. The comments of local exchange carrier ("LEC") competitors -- interexchange carriers, cable companies, competitive access providers and others -- argue for a full retreat from that goal. These competitors seek to use this proceeding to create additional regulatory controls that will hamstring LECs' ability to compete, and undermine

---

1 The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc . Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; and Bell Atlantic-West Virginia, Inc

2 Second Further Notice of Proposed Rulemaking in CC Docket 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197 at ¶ 1 (rel. Sept. 20, 1995).

compete, and undermine their ability to offer customers new services and reduced prices. But putting competition thresholds as barriers to basic reforms of new service rules, or failing to implement a workable mechanism to allow market prices for services that face competition only benefits the competitors themselves, not the ultimate customers.

The Commission should reject increased regulation and instead should adopt the reforms proposed by Bell Atlantic, which will meet the goals the Commission has set out for this proceeding. These reforms include baseline changes that should be adopted irrespective of the level of competition. New services should be filed on one day's notice without required price support and with no subsequent price regulation.[3] In addition, other services should be removed from price regulation as soon as a competitive alternative is available.[4]

I. Baseline Reforms Should Be Implemented Regardless of the Level of Competition

A number of competitors argue that there should be a competitive threshold before any real reforms of new service rules are undertaken.[5] The baseline reforms are appropriate regardless of the level of competition. Moreover, these commenters fail to acknowledge the

---

3 ***See Price Cap Performance Review for Local Exchange Carriers***, CC Docket Nos. 94-1, 93-124, 93-197, Comments of Bell Atlantic at 1-2 (filed December 11, 1995) ("Bell Atlantic Comments").

4 ***Id.*** at 17.

5 ***See Price Cap Performance Review for Local Exchange Carriers***, CC Docket Nos. 94-1, 93-124, 93-197, Comments of MCI Communications Corporation ("MCI") at 21 (filed December 11, 1995) ("MCI Comments"); Comments of LDDS WorldCom at 34 (filed December 11, 1995) ("LDDS Comments"); Comments of AT&T Corp. ("AT&T") at 6-7 (filed December 11, 1995) ("AT&T Comments"); Comments of Sprint Corporation ("Sprint") at 22 (filed December 11, 1995) ("Sprint Comments").

range of competition that LECs face today and the continued expansion of that competition in the immediate future.

Competitors fail to explain any conceivable link between the restrictions they propose and new service rules. It is because, in fact, no such link exists. So long as existing basic services are regulated, new services either offer an alternative to a basic service -- and are therefore discretionary -- or are totally new services -- which are, by definition, discretionary.[6] Regardless of the level of competition, the marketplace can accept or reject these service offerings. Moreover, as GSA observes, increasing flexibility for new services, alternative pricing plans and volume and term discounts have a dual advantage: "[i]t allows carriers to set prices closer to the corresponding levels of cost, and it provides ratepayers with greater options in the manner in which they buy services."[7]

Indeed, the risk is not in adopting these changes, but in failing to adopt them. As Dr. Jerry Hausman explained, "regulatory delays of new service decrease both consumer gains and

---

[6] Bell Atlantic has recognized the need to exempt certain essential interconnection services from its proposals. Bell Atlantic Comments at 13, n.. 43. As explained by Professor Kahn and Dr. Tardiff, this is a very limited subset of new services. Alfred E. Kahn and Timothy J. Tardiff, ***Changes in Interstate Price Regulation: An Economic Evaluation of the Pacific Bell and Nevada Bell Proposal*** at 9 ("Kahn and Tardiff Report"), attached to Comments of Pacific Bell and Nevada Bell, CC Docket Nos. 94-1, 93-124, 93-197 (filed December 11, 1995).

[7] ***Price Cap Performance Review for Local Exchange*** Carriers, CC Docket Nos. 94-1, 93-124, 93-197, Comments of the General Services Administration ("GSA") at 5 (filed Dec. 11, 1995) ("GSA Comments").

economic efficiency significantly."[8] The result of this delay is that consumers forfeit "billions of dollars per year."[9]

In contrast, there is no reason for the blanket regulation that these services are currently subject to.[10] Today's regulation unfairly targets a single segment of the industry for restrictive regulation, thereby ensuring an uneven playing field as competition expands. The only parties to benefit from such an arrangement are the competitors that advocate continued controls.[11]

In addition to pricing flexibility for new services, the Commission should adopt downward pricing flexibility for existing services without constraint. Competitors argue that downward pricing flexibility for existing services should be constrained by limiting subsequent upward changes.[12] But as GSA cogently points out: "This constraint would virtually guarantee that every price reduction would generate a net loss of revenue to the LECs."[13] Of course the

---

8 Statement of Professor Jerry A. Hausman, ¶ 7 ("Hausman Statement"), attached to Comments of BellSouth Telecommunications, Inc., CC Docket Nos. 94-1, 93-124, 93-197 (filed Dec. 11, 1995).

9 ***Id.***, ¶ 31.

10 Without citation, Ad Hoc argues that requiring aggrieved customers to rely on the complaint process to address concerns over new service tariffs is inconsistent with the Communications Act. Comments of Ad Hoc Telecommunications Users Group at 5, n. 12 (filed Dec. 11, 1995). In fact, the Act specifically provides that, as a result of a complaint, the Commission may find a tariff charge unlawful and modify that charge. 47 U.S.C. § 205 (a). The Commission already allows the vast majority of common carriers to file ***all*** tariffs, including modifications to existing tariffs, on one day's notice. ***Tariff Filing Requirements for Nondominant Carriers***, 10 FCC Rcd 4074 (1995).

11 The commenters were not able to identify any true benefits of the rules. For example, AT&T argued that Part 69 waivers are necessary to maintain a non-discriminatory rate structure. AT&T Comments at 33-34. In fact, the vast majority of waivers were granted as filed, so the only result of the regulation is to delay the introduction of new Switched Access services.

12 ***See, e.g.***, MCI Comments at 1; AT&T Comments at 21-22.

13 GSA Comments at 7.

result would be to discourage LECs from lowering their prices and thereby locking themselves in to the lower rate. While this result may benefit the LECs' competitors, it is not sound public policy.[14]

In the context of this argument, several competitors argue that upward price flexibility or "headroom" for services priced below the cap is harmful.[15] In fact, the opposite is true. One of the benefits of price cap regulation is to allow LECs to mimic competitive markets by pricing the most price elastic services most aggressively.[16] This means LECs would maintain relatively higher margins on those services with relatively lower price elasticity. Moreover, as prices are deregulated with the advent of competition, there will be price adjustments to better reflect actual market conditions. "Just as there are rate elements that are priced above cost, so there are likely to be other elements that are priced below costs."[17] As explained by Professor Kahn and Doctor Tardiff: "Both economic efficiency and the promotion of competition require that the prices of under-priced services increases."[18]

Cable Television companies argue that any kind of pricing reforms should be rejected because of the potential to cross subsidize competitive services with excess profits from

---

14 Professor Hausman cites the example of a similar restriction in California's regulation of cellular telephone prices. As long as the restriction was in place, prices did not fall. As soon as the restriction was lifted, there was a significant price reduction. Hausman Statement, ¶ 17.

15 ***See, e.g.***, LDDS WorldCom Comments at 12-16.

16 ***See*** Hausman Statement, ¶¶ 16-17. ***See also*** Affidavit of Richard J. Gilbert and Robert G. Harris, ¶ 1 ("Gilbert and Harris Affidavit"), attached to Bell Atlantic Comments.

17 GSA Comments at 7.

18 Kahn and Tardiff Report at 7.

regulated services.[19] In support, they argue that even pure price caps do not fully server the link between cost and prices because regulators will always look at earnings measures in subsequent evaluations.[20] Such a cross subsidy argument makes no sense. Even if the Commission were to succumb to a reliance on earnings to set the productivity factor, which it should not, there would be no way of a LEC knowing how much, if anything, it might recover for its under-pricing of a competitive service. Moreover, productivity is set for an entire industry, thus no company can be assured of ***any*** recovery regardless of its own performance. It would thus be "foolhardy" to set prices to lose money in the vague hope that future regulatory changes would somehow make up for that loss.[21]

Even if recovery of losses were possible and predicable, which it is not, predation serves no reasonable goal. As explained by Kahn and Tardiff, current competitors are not likely to be driven out and even if they were, the facilities they have built will remain:

> "[F]irms do not exit from markets unless the prices fall and are held below their variable costs; and the very wide gap between total costs and marginal costs of capacity already in place suggest that any attempt at predation would in any event be extremely costly; the predator would have to push prices far below its own total costs and suffer large losses before it would have any hope of driving out its rivals from the market. Moreover, even if [the LEC's] price reductions drove out such particularly unlikely targets for successful predation as AT&T [and the cable industry], they would not drive out facilities already installed" . . . "at that point,

19 Declaration of Leland L. Johnson, Ph.D. at 2 ("Johnson Declaration:), attached to Comments of the National Cable Television Association, Inc., CC Docket Nos. 94-1, 93-124, 93-197 (filed December 11, 1995).

20 Regardless of the merits of their arguments here, they do reinforce the need for the Commission to move to a truly pure price cap system with no sharing and no regulation of depreciation rates.

21 ***See*** Supplemental Affidavit of William E. Taylor, Ph.D., ¶¶ 18-20 ("Taylor Supplemental Affidavit"), attached to Reply of Bell Atlantic to Comments and Oppositions Concerning Direct Case, ***Amendment to the Bell Atlantic Telephone Companies Tariff FCC No. 10***, CC Docket No. 95-145, (January 11, 1996).

the facilities already in place, it would pay someone to resume - whether the previous rivals or some successor firm - operating them."[22]

Increased pricing flexibility for new services changes none of the economic logic -- LECs will still have to price ***all*** its services above incremental cost.

II. Where a Competition Test is Required, It Should Be a Relevant Test

For existing services, price restraints should be removed as soon as a competitive alternative is available.[23] Once even a portion of customers can switch service providers at relatively low cost, the alternate provider(s) serve as a market check on prices and regulatory price controls are no longer necessary or appropriate.[24]

Those who argue that the Commission delay setting a framework because there is no competition are simply wrong. First, it makes no sense not to have rules in place, regardless of the level of competition. Second, as Professors Harris and Gilbert explain, competition is here today and is poised for dramatic growth.[25] Indeed, almost every major metropolitan statistical area in the country already has at least one competitive access provider ("CAP") in operation.[26]

---

22 Kahn and Tardiff Report at 12. The same logic explains why a price squeeze makes no economic sense. LDDS WorldCom argues that a price squeeze exists in New Jersey because Bell Atlantic's access charges exceed Bell Atlantic's toll charges. LDDS WorldCom Comments at 15 (filed Dec. 11, 1995). LDDS makes its argument by selectively isolating Bell Atlantic's cheapest toll rates. In fact, Bell Atlantic-New Jersey's price for an average toll call is more than twice as high as its equivalent access charges. ***See*** New Jersey Public Utilities Commission, Docket No. TX94090388, Rebuttal Testimony of Harold E. West at 13-14 (filed May 31, 1995).

23 Comments of Bell Atlantic at 16.

24 Gilbert and Harris Affidavit, ¶ 32.

25 ***See*** Reply Affidavit of Richard J. Gilbert and Robert G. Harris, ¶¶ 15-32, attached hereto ("Gilbert and Harris Reply Affidavit"). ***See also*** Bell Atlantic Comments at 2-3.

26 ***See*** Comments of United States Telephone Association, Attachment II, CC Docket Nos. 94-1, 93-124, 93-197 (filed December 11, 1995) ("USTA Comments").

This does not include other competition such as wireless bypass. One company which offers "last mile" wireless access connections to interexchange carriers, Caps and corporate users that wish to bypass the LECs network now operates "in 28 of the largest U.S. metropolitan areas, covering more than 100 million people and 60% of corporate America."[27] Moreover, since all three long distance carriers have committed to offer direct competition for local service, they will increasingly rely on CAPs or their own facilities in favor of the LEC's access service.[28] Because LEC access services are so dependent on the three major interexchange customers, the LECs' competitive position is far more vulnerable than AT&T with its widespread customer base.[29]

Several competitors seek to place the level of local ***intra***state service competition as a test for removal of price regulation for ***inter***state access services. For example, AT&T argues that no service can be found to have competition when a downstream market for that service is not sufficiently competitive.[30] AT&T is wrong. The test for removal of price regulation must focus on the actual services to be removed. As Drs. Schmalensee and Taylor explain, "[i]f IXCs have multiple sources for carrier access facilities, then the LEC is unable to affect the market price for carrier access irrespective of its ability to affect the market price in a downstream toll market."[31] AT&T's proposal would hold access services hostage until AT&T is fully competitive with ***all***

---

27 M. Dziatkiewicz, "Wireless Fiber Offers Carriers Bypass, Competition," ***America's Network*** at 42 (April 15, 1995).

28 Bell Atlantic Comments 4-5.

29 Thus, it makes no sense to rely on the model used to evaluate removal of price regulation for AT&T.

30 ***See*** B. Douglas Bernheim, ***An Analysis of the FCC's Proposal for Streamlined Regulation of LEC Access Services*** at 4 ("Bernheim Report"), attached to AT&T Comments.

31 Richard Schmalensee and William Taylor, ***Pricing Flexibility for Interstate Carrier Access Services: Reply Comments***, attached to Reply Comments of USTA (filed Jan. 11, 1996).

LEC services. Such a regulatory policy does not serve consumers interests and only benefits AT&T and other LEC competitors.

AT&T also argues that LEC services should be evaluated in broad groupings.[32] To the extent that this means that LECs should be permitted to group cross-elastic services together for purposes of removal from price caps, AT&T is right. What AT&T fails to understand, is that so long as a LEC can make a showing of a competitive alternative, any grouping of services should be preemptively reasonable. To the extent the LEC fails to include services that are cross-elastic with the selected services, it will have to make an independent showing at such time it seeks to remove the remaining services from regulation.[33] To the extent a LEC combines services that are not cross elastic, other parties will have the opportunity to argue that the competitive alternative demonstrated by the LEC has no relevance to a segment of the services proposed to be removed. In either scenario, there is no reason for the Commission to prejudge the relevant groupings until the appropriate showing is made.[34]

Similarly, a number of competitors argue that, regardless of the level of competition for a particular service grouping, a generic checklist must be met before the Commission can remove a

---

32 Bernheim Report at 3-11.

33 Of course, part of the competitive showing for the second service could be evidence that a competitor exists for a cross-elastic service. So long as the showing establishes that customers have a competitive alternative, there is no reason for continued price regulation. ***See*** Gilbert and Harris Affidavit, ¶ 6.

34 Indeed, the same is true for groupings based on geography, or customer-segment. So long as the LEC can show that a competitive alternative exists for the proposed groupings, they should be removed from price regulation.

service from price regulation.[35] Compliance with a checklist tells the Commission nothing about whether competitive alternatives exist for specific services, customer groups or geographic areas.[36] Where there is a specific competitive alternative, a generic checklist is meaningless and offers no basis to retain price regulation.

Market share is another benchmark advocated by competitors[37] that should be rejected by the Commission.[38] As AT&T has acknowledged "market share is the least important and least reliable indicator of market power."[39] Instead, the Commission should rely on forward looking measures of competition such as the 25% addressability standard advocated by Bell Atlantic.[40]

Several competitors argue that there cannot be pricing flexibility for the LECs out of concern for the potential abuse should the LECs be authorized to provide long distance service.[41] Even if the pending legislation becomes law and LECs are allowed into the interLATA business, it will have no impact on the issues here. First, a troika of current carriers has more than 85% of the market[42] and any LEC must establish itself as a new supplier. Second, and more

---

35 ***See*** Sprint Comments at 26; MCI Comments at 32; AT&T Comments at 17; Comments of Time Warner Communications Holdings, Inc. at 29, CC Docket 94-1 (filed December 11, 1995).

36 For example, some of the proposed checklist items include unbundled loops, uniform standards for interoperability, and number portability. None of these has anything to do with whether a competitive alternative exists for specific interstate services.

37 ***See, e.g.***, AT&T Comments 17-18.

38 ***See*** Gilbert and Harris Affidavit, ¶ 36; Gilbert and Harris Reply Affidavit, ¶¶ 33-35.

39 ***Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorization***, CC Docket No. 79-252, AT&T Reply at 11 (filed June 30, 1995).

40 ***See*** Gilbert and Harris Affidavit, ¶ 35.

41 ***See e.g.***, LDDS WorldCom Comments at 14-16; CompTel Comments at 14-15.

42 ***See*** Federal Communications Commission, ***Statistics of Communications Common Carriers*** at 7, 1993/1994 Edition.

fundamentally, none of the reforms proposed by Bell Atlantic is in any way related to LEC's offering long distance service.[43] The baseline reforms provide greater incentive for new services[44] and lower prices without affecting the Commission's ability to continue to enforce rules that protect against any possible anticompetitive conduct. InterLATA services will be subject to the separate rules and safeguards finally determined appropriate in the pending legislation.

To the extent that competitors' underlying argument is that access rates are simply too high,[45] their criticisms are misplaced. This is the wrong forum to argue over the level of access rates. Nevertheless, it is undeniable that interstate rates were cost-based and deemed reasonable

---

43 A related argument is that incumbent telephone companies will benefit from certain advantages in offering their competitive long distance service with their regulated services. As Kahn and Tardiff explain, however, "these are precisely the economies of scope that strongly recommend permitting -- even encouraging -- them to expand their operations in the competitive sectors." Kahn and Tardiff Report at 10. Of course, the incumbents have economies of scope of their own. Professor Kahn explains that the appropriate policy result in such a situation is that regulators should let "all competitors -- including the incumbent companies -- reflect in their prices whatever economies are available to them." A. Kahn, regular commentary, PBS program. Nightly Business Report, November 8, 1985.

44 Commenters complain that LECs will craft new service offerings that will only benefit their affiliated long distance carrier. ***See e.g.***, CompTel Comments at 14-15. They fail to acknowledge that common carrier rules will still apply and any service offering will be available to them as well. To the extent they believe there is ***unreasonable*** discrimination in the terms of the new service offerings, the complaint process will afford them an avenue for hearing and, if appropriate, relief. Despite the continued existence of this remedy, they argue that the Commission should limit LECs' ability to introduce ***any*** new service, regardless of whether there could even be a colorable discrimination claim associated with that service. This suggests that potential LEC entry into the interLATA market is being used as a red herring in an argument for unwarranted generic limitations on LEC service introduction and pricing.

45 ***See*** CompTel Comments at 4; LDDS WorldCom Comments at 14; MCI Comments at 20-21.

going into price caps[46] and have been reduced year after year by an offset that exceeds the achieved LEC industry total factor productivity growth.[47] It is appropriate that as part of the upcoming access reform docket, the Commission should allow reduction of the Common Carrier Line rates with offsetting increases to the Subscriber Line Charge.[48] The need for those reforms, however, should not be used as an excuse to delay implementation of the fundamental pricing flexibility reforms proposed here.

Finally, while Bell Atlantic advocates moving operator services into the interexchange basket along with other services that compete with interexchange carriers, MCI argues that there is no real competition for call completion services.[49] In fact, MCI itself heavily advertises its "1-800-Collect" calling service, which bypasses Bell Atlantic's call completion service.[50] In addition, more than 58,000 private pay phones in Bell Atlantic's service territory are

---

[46] ***See Policy and Rules Concerning Rates for Dominant Carriers***, 5 FCC Rcd 6786, ¶ 232 (1990).

[47] ***See Price Cap Performance Review for Local Exchange Carriers Fourth Further Notice of Proposed Rulemaking***, CC Docket No. 94-1, Comments of Bell Atlantic on the Fourth Further Notice of Proposed Rulemaking (filed January 11, 1996).

[48] ***See*** Bell Atlantic Comments at iv.

[49] ***Compare*** Bell Atlantic Comments at 23-24 ***with*** MCI Comments at 20. AT&T argues that Line Information Data Base Service (LIDB) should have additional price restrictions placed on them because of authorized price increases by Bell Atlantic and other LECs. AT&T Comments at 54. In fact, AT&T, which is under no regulatory price constraints has raised its own equivalent Billing Verification service rates 30%.

[50] In 1994, MCI spent $44 million on such advertising. Moreover, AT&T, MCI and Sprint handle 80% of the total operator service minutes for calls placed by consumers away from home. ***See*** FCC Report: Telephone Operator Consumer Services Act, Final Report, Attachment N at 5 (Graph 2) (Aug., 1992).

presubscribed to other operator services. Moreover, prepaid phone cards, which have become increasingly popular,[51] bypass Bell Atlantic's operator services.

CONCLUSION

For the foregoing reasons, the reforms proposed by Bell Atlantic should be adopted.

Respectfully submitted,

Michael E. Glover
Edward Shakin

1320 North Court House Road
Eighth Floor
Arlington, VA 22201
(703) 974-4864

Attorneys for the
Bell Atlantic Telephone Companies

Edward D. Young, III
Of Counsel

January 16, 1996

[51] ***See, e.g.***, Atlanta Constitution, "Prepaid Cards for Phones Calls Gain Popularity," at E3 (Aug. 14, 1995).

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing "Bell Atlantic Reply Comments" was served this 15th day of January, 1996 by hand on the parties on the attached list.

Tracey DeVaux

Tracey DeVaux

Tariff Division
Federal Communications Commission
1919 M Street, N.W. Room 518
Washington, D.C. 20554

ITS, Inc.
1919 M Street, N.W.
Room 246
Washington, D.C. 20554

(2 copies)

Industry Analysis Division
1919 M Street, N.W.
Room 534
Washington, D.C. 20554

(Computer Version)

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Treatment of Operator Services Under Price Cap Regulation	)	CC Docket No. 93-124
	)	
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

REPLY AFFIDAVIT OF RICHARD J. GILBERT AND ROBERT G. HARRIS

A. PURPOSE AND SUMMARY OF THE REPLY AFFIDAVIT

1. In this affidavit we respond to arguments by competitors of the Local Exchange Carriers (LECs) that would prevent the LECs from truly competing by introducing new and less costly services. We also reiterate the conclusion expressed in our opening affidavit that removing regulatory barriers to the introduction of new services by the LECs and providing these companies with pricing flexibility, subject only to a requirement that they price above incremental cost, is pro-competitive and strongly in the public interest. Our proposal promotes competition and consumer welfare by removing artificial barriers to the introduction of new services and by confining price regulation only to those services that continue to demonstrate natural monopoly characteristics.

2. Competitors of local exchange companies (LECs) have proposed economically irrational standards for allowing LECs pricing flexibility or any other measure of regulatory freedom. These standards do not promote consumer welfare, but instead promote the economic interests of competitors who stand to benefit from restrictions on

the abilities of LECs to compete. We show how lessons from the regulatory history of other industries warns against accepting these arguments. We also again explain why, contrary to the complaints of competitors, the public benefit associated with removing regulatory obstacles to new services and price changes is not dependent on the degree of current competition. Regardless, as we demonstrate, competition today is far more widespread than suggested in the comments of the interexchange carriers and others. Finally, for existing services, we explain why certain measures of competition are inappropriate.

B. COSTS OF ASYMMETRIC REGULATION, BENEFITS OF REGULATORY SYMMETRY

3. The comments of LEC competitors ignore important experiences in other industries. The parallels between the regulation of railroads, banks, and LECs provide some important lessons for telecommunications policy in general and tariff and price cap reforms in particular.[1]

- First, the myth of monopoly pervaded the railroad and banking industry long after the demise of their monopoly power, just as it apparently is in the case of local exchange carriers and the access markets.

- Second, the competitors of railroads and banks played a major role in sustaining asymmetric regulatory policies long after they had become counter-productive because those policies were a crucial source of competitive advantage for motor

[1] For a more complete discussion of the analogies and parallels between telecommunications, financial services, and surface freight regulation see Robert G. Harris, Toward Regulatory Symmetry in Local Exchange Services: Lessons from Financial Services and Freight Transportation, December 14, 1995, to be presented to the Industrial Organization Society, Allied Social Science Associations.

carriers and diversified financial service providers, just as CAPs and other new entrants now advocate asymmetric regulations that inhibit LECs from meeting them fairly in the marketplace.

- Third, the price structures of rail and banking services, incorporating rate averaging and cross-subsidies, were not sustainable in a competitive environment, just as the current structure of LEC access services prices is not.

- Fourth, while regulators based their policies on intramodal competition (i.e., competition among banks, or among railroads), the most powerful market forces were intermodal competition (i.e., between railroads and motor carriers, or banks and other financial institutions). Competition in telecommunications will include intermodal competition as LECs, new entrants, cable operators, wireless carriers, satellite systems and other modes of communications compete to meet customer needs.

- Fifth, in financial services regulation, for many years, banks were not allowed to introduce innovative new services such as interest-bearing checking accounts or proprietary mutual funds because they were not allowed to engage in nonbanking financial activities. However, bank competitors such as Merrill Lynch, were able to introduce new services at will and gained substantial market share at banks' expense. Similarly, LECs can only introduce new access services after long regulatory delays but non-LECs such as CAPs and wireless providers are able to introduce new access services as soon as they can get them to market.

- Sixth, banks were severely limited in their pricing flexibility by Regulation Q which restricted the interest rates they could pay on deposits. Nonbank competitors did not suffer the same interest rate restrictions and prospered as a result. Similarly, price cap rules such as service band indices and geographic averaging requirements prevent

LECs from changing the prices of access services as competition intensifies, but their competitors can set and change their prices without restraint.

4. The vital lesson from the freight transportation and financial services industries is that as competition develops, it is important that regulations enable incumbents and entrants to compete vigorously. The worst possible results are caused by regulations that give artificial advantages to some firms over others. In surface freight transportation, those regulatory advantages were heavily biased in favor of motor carriers. Market forces will feed off those artificial advantages; it did not matter that the cost of rail service for a given shipper was lower than the cost of truck service, when the rail carrier was forced to charge a higher price. It did not matter to a shipper that rail was a more efficient means of transport than truck if the rail carrier was prevented from realizing those potential efficiencies. Many of the nation's railroads were forced into severe financial distress in the 1960s and 1970s due to asymmetric regulatory policies. After a great deal of economic dislocation and lost efficiencies, the regulatory reforms of 1980 eventually restored competitive balance between rail and motor carriers. Not surprisingly, today both industries are more efficient, offer lower prices and better service, and are financially healthy. In financial services, banks suffered from financial disintermediation (the loss of deposit and loan customers), bank earnings were reduced and the stability of the financial system was undermined when banks were unable to price their deposits at market levels. Similarly, LECs' earnings and profitability will be substantially reduced if high volume customers continue to chose alternatives to LEC services because regulatory requirements result in prices above competitive levels and new services are inhibited by outmoded regulation. These examples demonstrate that regulators should be careful not to handicap current providers in favor of new entrants. For competition to succeed in promoting economic efficiency, the Commission must relax its tariff filing and pricing

rules to allow prices to send the correct signals to the market. Otherwise, the Commission will promote economically inefficient entry.

5. Given the escalating competition in telecommunications services, the Commission should adopt policies which reflect vigorous competition, not the market conditions of the past. Increasing competition also means that policy makers have a direct interest in ensuring that LECs have a fair opportunity to compete in the fastest growing, most profitable market segments of telecommunications. If LECs are handicapped in competing for the most profitable market segments, they will be less able to provide low-cost, high-quality service to the other market segments and will have diminished financial incentives to invest in the telecommunications infrastructure -- especially in rural, high cost areas.

C. THE RATIONALE FOR REMOVING REGULATORY OBSTACLES TO NEW SERVICES AND PRICE CHANGES IS NOT DEPENDENT ON THE DEGREE OF COMPETITION IN ACCESS SERVICES

6. Under the current price cap regime there is no valid economic argument for retaining rules such as the Part 69 waiver process, or tariff notice and cost filing requirements, that delay the introduction of new services. Nor is there any valid argument for continuing to subject new services generally to any form of price cap regulation. So long as existing services remain available to customers at their old prices when new services are introduced, new access services increase competition and improve efficiency in all cases. The economic logic for this proposition is straightforward: any new service offering will always make customers better off in the aggregate, provided there is no change in the prices and availabilities of existing services, because customers will have more choices with the new service than before. Similarly, LECs should be given complete flexibility for downward adjustments to existing price cap services that remain subject to regulation,

thereby allowing LECs to respond to changing market conditions by changing their prices. Significantly, all of these changes will promote competition and benefit consumers regardless of the current degree of competition for the LECs' access services.

7. Nonetheless, a number of the LECs' competitors argue here that no further flexibility should be granted to the LECs without a preliminary showing of extensive competition. As the outset, it is important to recognize that the interest of these competitors in preventing competition. For example, AT&T and other IXCs have strategic interests vis-à-vis the LECs to raise regulatory thresholds imposed on RBOCs to prevent them from entering the long distance business. In addition, AT&T and other providers of access and exchange services such as cable companies and competitive access providers (CAPs) have a strategic interest in imposing regulatory constraints on incumbent LECs to obtain a competitive advantage. A recent *Wall Street Journal* report states that AT&T is currently installing "more than 100 switches to route local calls in virtually every Bell market"[2] in preparation for the opening of the local exchange market. The article goes on to say: "People inside AT&T say the company plans a massive first strike against the Bells, hoping to penetrate all 50 states with a special bundle of services."[3] Thus, in evaluating comments by AT&T and other competitors here, it should be kept in mind that these parties have an economic interest to use the regulatory process to protect their position in their core businesses and to gain a strategic advantage over LECs as they expand their presence in the local exchange, and exchange access businesses.

8. Moreover, the arguments made by the LECs' competitors are without merit. For example, in an affidavit submitted on behalf of AT&T, Dr. Bernheim argues that LECs

---

[2] "AT&T Eagerly Plots to Gobble Local Phone Business," The Wall Street Journal, August 21, 1995, p. A1.

[3] Ibid.

should be denied pricing flexibility absent proof that they face ubiquitous competition, not only in the relevant market for any given access service, but in all markets for downstream services that rely on the access service at issue. Not only is this proposal contrary to the recognition by regulators in other industries that regulation should be confined only to monopoly services, but AT&T wholly fails to explain how extensive tariff filing requirements or extended filing delays in any way promote competition.

9. The need for the baseline changes we have recommended is <u>not</u> dependent on effective competition or any other threshold level of competition. Dr. Bernheim's position that LECs should not be granted pricing flexibility or expedited tariff filing are directly contradicted by the Comments of the General Services Administration, which cogently explain that:

> "If the Commission waits until competitors are fully developed to allow [LECs] to compete, it will be faced with countless appeals by relatively inefficient parties to keep [LECs'] pricing umbrella in place. By granting [LECs] pricing flexibility at the outset, the Commission will be ensuring that the growth of competition benefits the users of telecommunications services, and not just the competitors."[4]

10. On behalf of the National Cable TV Association, whose members have an economic interest to maintain a LEC price umbrella to facilitate their entry into local access and exchange services, Dr. Leland Johnson incorrectly argues that either earnings sharing or "implicit" rate of return regulation justify continuation of undue regulatory restrictions that delay new access services and constrain price competition in access services. There are at least four reasons to reject this contention.

[4] GSA, "Pricing Flexibility within the Price Cap Plan," Quoting from Reply Comments on Ameritech's plan, pp. 5-6

11. First, the Commission requires, through its Part 64 rules, cost allocation methods that provide adequate protection against cross-subsidization between unregulated and regulated services. In fact, these rules actually require that LECs allocate their costs to their competitive services well in excess of the incremental costs of those services. Even Dr. Johnson has admitted that "so long as each service bears no less than its incremental cost, no subsidy would flow from one to the other."[5] As we stated in our initial affidavit and reaffirm here, LECs should be subject to an incremental cost-based price floor on all of their services. If LECs try to employ predatory pricing strategies the Commission can investigate based on competitors' complaints and competitors can challenge any such practices under the antitrust laws.

12. Second, Dr. Johnson greatly overstates the ability to exclude competition for competitive interstate services, even when a LEC is under rate of return regulation for intrastate services. A predatory pricing strategy is unlikely to be successful in eliminating competition for local exchange services. Predation requires that a LEC sustain large losses to destroy potential competitors. LEC competitors include many financially strong companies such as AT&T, MCI, Sprint and diversified cable and construction concerns. These companies have pockets deep enough to outlast a predatory attempt by a LEC. Furthermore, even if a LEC succeeded in eliminating a new entrant, the entrant's network would still be in place and could be purchased at a substantial discount by another competitive entrant who could provide service at a very low cost.

13. Third, as Dr. Johnson acknowledges, in a pure price cap regime, the alleged predator could not recoup the costs of predation. Recoupment also would be very difficult even in an "impure" price cap regime. By definition, cross-subsidizing competitive services

[5] Petition to Deny Pacific Bell's Section 214 Video Dial Tone Applications of the California Cable Television Association, Attachment 2: Affidavit of Leland L. Johnson, February 7, 1994, p. 7.